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Explanatory Guide to Exposure Draft 02/10

Review of a Financial Report - Company Limited by Guarantee

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The AUASB issues Explanatory Guide to Exposure Draft 02/10 *Review of Financial Report - Company Limited by Guarantee*. This Explanatory Guide is intended to provide a background to and overview of ED 02/10 and therefore, does not establish or extend the proposed requirements and application of other explanatory material which are proposed in ED 02/10.

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Review of a Financial Report - Company Limited by Guarantee

PURPOSE

1. The purpose of this explanatory guide is to provide information on the context within which the Auditing and Assurance Standards Board (AUASB) has issued Exposure Draft 02/10 Proposed Auditing Standard on Review Engagements ASRE 2415 *Review of a Financial Report - Company Limited by Guarantee.*

BACKGROUND [1]

2. Under the existing reporting framework, all companies limited by guarantee are required to prepare an audited financial report in accordance with the Australian accounting standards and a directors' report in accordance with the *Corporations Act 2001* (Corporations Act), regardless of their size.

3. The company limited by guarantee structure is used predominantly by not-for-profit entities to incorporate their operations.

4. The vast majority of companies limited by guarantee are relatively small. The small size of companies limited by guarantee means that they may not have the capacity to comply with extensive reporting requirements. However, it is recognised that reporting by companies limited by guarantee is an important governance and transparency mechanism given the public nature of these companies.

5. In June 2007, The Australian Treasury released a discussion paper on financial reporting by unlisted public companies. The paper sought comments on whether the existing reporting framework was appropriate for the 11,000 companies limited by guarantee and the 7,000 unlisted public companies limited by shares preparing financial reports under the Corporations Act. The majority of respondents to the discussion paper indicated that for reporting purposes, companies limited by guarantee could be differentiated on the basis of the size of their operating revenue. Tests based on assets or number of employees may not be accurate indicators of the 'size' of the company.

[1] See also *Explanatory Memorandum*, Corporations Amendment (Corporate Reporting Reform) Bill 2010 — circulated by the authority of the Minister for Financial Services, Superannuation, Corporate Law and Human Services.

Summary of proposed new law - Corporations Amendment (Corporate Reporting Reform) Bill 2010

6. Under the Corporations Amendment (Corporate Reporting Reform) Bill 2010, which is currently under consideration in the Australian Parliament, a three tiered differential reporting framework will be introduced exempting small companies limited by guarantee from reporting and auditing requirements and providing other companies limited by guarantee with streamlined assurance requirements and simplified disclosures in the directors' report. In addition, the process for companies to distribute the annual report to their members will be streamlined.

7. Companies limited by guarantee will be prohibited from paying a dividend, as the corporate structure of companies limited by guarantee means that they are not suited for conducting for-profit activities which could legitimately warrant the payment of dividends to members.

8. This proposal is aimed at introducing a tailored financial reporting regime for companies limited by guarantee that will reduce the regulatory burden on these entities while ensuring that appropriate levels of financial transparency and governance are maintained.

Differential reporting framework

9. Under the proposed new law, a three tiered differential reporting framework will be introduced for companies limited by guarantee.

10. Under the first tier, companies would be exempt from preparing the financial report and the directors' report. As a result, companies in this tier would not be required to have the annual report audited, or be required to appoint an auditor. This tier comprises companies limited by guarantee with annual revenue less than $250,000 and which do not have deductible gift recipient status.

11. Under the second tier, companies would:

    - prepare a financial report, which they could elect to have reviewed rather than audited;
    - prepare a streamlined directors' report, rather than a full director's report; and
    - be subject to a streamlined process for distributing the annual report to members.

    The second tier comprises the following companies limited by guarantee:

    - companies with an annual revenue of less than $250,000 that are a deductible gift recipient; and
    - companies with an annual revenue of $250,000 or more but less than $1 million, irrespective of whether the company is a deductible gift recipient.

12. Under the third tier, companies would:

    - continue to prepare an audited financial report;
    - prepare a streamlined directors' report, rather than a full director's report; and

- be subject to a streamlined process for distributing the annual report to members.

The third tier comprises companies limited by guarantee with an annual revenue of $1 million or more, irrespective of whether the company is a deductible gift recipient.

Audits and reviews

13. The current framework requires companies limited by guarantee to have their financial reports audited by a registered company auditor in accordance with Australian auditing standards. Stakeholders have suggested that many small companies limited by guarantee are currently spending a disproportionate amount on audit fees. This reduces the resources that the company has available for member services.

14. Under the new law, companies falling within the second tier would be given the option of having their annual report subject to a review, rather than an audit. [Schedule 1, Part 1, item 30, subsection 301(3)]

15. A review, in contrast to an audit, is not designed to obtain reasonable assurance that the financial information reported by the company is free from material misstatement. A review consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review may bring significant matters affecting the financial information to the assurance practitioner's attention, but it does not provide all of the evidence that would be required in an audit.

16. This measure is intended to reduce the time and costs associated with having the financial statements audited, whilst ensuring that the financial information is still subject to an appropriate degree of assurance.

17. The review would be conducted in accordance with a standard on review engagements developed (and modified as appropriate) by the Auditing and Assurance Standards Board (AUASB). [Outlined in ED 02/10]

18. The review could be undertaken by either a registered company auditor, or a member of a professional accounting body that holds a prescribed practising certificate. [Schedule 1, Part 1, item 45, section 324BE]

19. The associated regulations prescribe the following practising certificates:

    - the Certificate of Public Practice issued by the Institute of Chartered Accountants in Australia (ICAA);
    - the Public Practice Certificate issued by CPA Australia Ltd or the National Institute of Accountants (NIA).

20. This measure will expand the category of individuals that are permitted to undertake a review, which will provide greater flexibility and reduce unnecessary burden on companies limited by guarantee and their auditors, particularly during peak periods.

RELEVANT PRONOUNCEMENTS

AUASB

21. Under the existing *Framework for Assurance Engagements* (April 2010), reviews are recognised as providing limited assurance. This is contrasted to audits that provide reasonable assurance. The Australian framework is consistent with the equivalent framework issued by the International Auditing and Assurance Standards Board (IAASB).

22. At the date of this explanatory guide, the following relevant standards issued by the AUASB, are operative:

    - ASRE 2400 *Review of a Financial Report Performed by an Assurance Practitioner Who is Not the Auditor of the Entity*
    - ASRE 2405 *Review of Historical Financial Information Other than a Financial Report*
    - ASRE 2410 *Review of a Financial Report Performed by the Independent Auditor of the Entity*

    [The current version of ASRE 2410 is in clarity form and is operative from 1 January 2010.]

AUASB DECISIONS AND APPROACH

AUASB Decisions

23. Given the current standing of the AUASB framework and its review standards; and the continuing international revision project, the AUASB has decided that in order to provide a suitable standard for auditors conducting a review of a company limited by guarantee (see background information at paragraphs 1 to 22 above), the appropriate course of action is to issue a "transitional standard" that directs the auditor to pre-existing standards.

24. The AUASB does not consider the proposed changes in legislation to be sufficiently significant to warrant the development of a new review standard that differs substantively in terms of procedures, reporting and the level of assurance provided, from existing review standards, both in Australia and overseas.

25. In due course, the AUASB will consider the revised international standard, ISRE 2400, when issued, to determine the appropriate action regarding Australian standards.

AUASB Approach

26. The AUASB has developed a concise standard that directs the practitioner to the appropriate (pre-existing) review standard—ASRE 2400 or ASRE 2410. The decision as to which standard is to be used is driven by whether or not the practitioner has conducted an audit of the company. The proposed title of the proposed standard is:

    ASRE 2415 *Review of a Financial Report – Company Limited by Guarantee*

27. When an audit of the previous financial report has been conducted, the auditor has gained an understanding of the entity and its environment through compliance with the Auditing Standards. Accordingly, ASRE 2410 is appropriate.

28. Where companies limited by guarantee have been in existence for some time and opt for a review of their financial report, it is reasonable to conclude that their auditors, appointed under the existing legislative regime, will generally be asked to perform the review.

29. On the other hand, when an auditor has *not* conducted an audit of the entity's (previous) financial report, as in the case of:

    - a newly incorporated company limited by guarantee; or
    - a newly appointed auditor with no previous experience of the company,

    the auditor will not have obtained an understanding of the company in accordance with Auditing Standards. Accordingly, ASRE 2400 is appropriate.